

ST 98-27

Tax Type: SALES TAX

Issue: Audit Methodologies and/or Other Computational Issues

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS**

**THE DEPARTMENT OF REVENUE
OF THE STATE OF ILLINOIS**

v.

XYZ CORPORATION, INC.,

Taxpayer

**No. 94-ST-0000
IBT # 0000-0000
NTL SF-199300000000000**

**Charles McClellan
Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION

Appearances: Diane M. Anderson, of Neal, Gerber & Eisenberg, for taxpayer: John Alshuler, Special Assistant Attorney General, for the Department of Revenue.

Synopsis:

This matter involves a Notice of Tax Liability ("NTL") issued to XYZ Corporation, Inc. ("taxpayer"), by the Department on December 21, 1993, for the period of January 1, 1989, through December 31, 1991.

A pre-trial order was entered on August 1, 1996, setting forth the issues, agreed to by the parties, as follows:

1. Whether the Department's interpretation of the so-called "10 percent rule" as it applies to professional photographers under Section 2-15 of the Retailers Occupation Tax Act ("ROTA")¹ is proper.

2. Whether the Department's interpretive audit policy is a "rule" within the meaning of the Illinois Administrative Procedure Act, 5 ILCS 100/1 *et seq.* because the Department has not formally adopted that position as a "regulation" or "rule" before applying it to the taxpayer or the general public. If so, does the fact that the Department has not formally adopted that position as a "regulation" or "rule" before applying it to the taxpayer or the general public constitute a violation of either: (1) the rulemaking requirements of the Illinois Administrative Procedure Act; (2) Section 3 of the Illinois Department of Revenue Sunshine Act, 20 ILCS 2515/3; or (3) the Due Process Clauses of the Illinois or U.S. Constitution.

3. Assuming the Department prevails under the first two issues, must the proposed assessment nevertheless be cancelled under Section 4(c) of the Taxpayers' Bill of Rights Act, 20 ILCS 2520/1 *et seq.*

4. Whether the taxpayer had reasonable cause for its failure to timely report and pay the assessment.

5. Whether the taxpayer is entitled to attorneys' fees and other litigation expenses pursuant to Section 10-55(c) of the Illinois Administrative Procedure Act, if the assessment is cancelled.

The parties entered into a stipulation and the taxpayer filed a Motion for Summary Judgment thereon. ("Motion"). It is that motion which is addressed here.² There being no

1. Unless otherwise noted, all statutory references are to 35 ILCS 120/1, *et seq.*, the Retailers' Occupation Tax Act.

² Although the Department filed a memorandum entitled "Brief in Opposition to Taxpayer's Motion For Summary Judgment (sic) In Support of Its Counter Motion For Summary Judgment", no such counter-motion was ever filed. Accordingly, this recommendation addresses the taxpayer's motion only.

dispute as to any material fact, on consideration, it is recommended that summary judgment be granted and the NTL be cancelled, without the imposition of fees or costs.

Findings of Fact:

1. Taxpayer was incorporated in Illinois in 1974 and is primarily engaged in the professional photography business. (Stip. Par. 1.)

2. In February 1992 the Department commenced an audit of taxpayer's books and records to determine compliance with the requirements of ROTA. (Stip. Par. 2.)

3. On December 21, 1993, the Department issued NTL SF-1993000000000000 to the taxpayer assessing ROT, penalty and interest of \$76,265 for the period of January 1, 1989, through December 31, 1991. (Stip. Par. 3, Stip Ex. No. 1.)

4. Taxpayer filed a timely protest. (Stip. Par. 4, Stip Ex. 2.)

5. All of the tax at issue relates to taxpayer's sales of wedding packages for calendar years 1990 and 1991, for which taxpayer charged Retailers' Occupation Tax ("ROT") on only 10% of the package price. (Stip. Par. 5.)

6. The Department has taken the position that the album pages, album covers and picture frames which are sold by the taxpayer as part of its wedding packages are subject to ROT and taxable on 100% of their "selling price". *Id.*

7. The Department calculated an imputed selling price for the album pages and covers, and the picture frames using its best judgment and information. (Stip. Par. 6.)

8. The tax in issue was calculated at the applicable ROT rate on 90% of such imputed sales, because taxpayer already charged ROT on 10%. *Id.*

9. 88% of the tax at issue is attributable to album pages and covers, and 12% for the frames. *Id.*

10. Taxpayer and its photographers are "professional photographers" for purposes of § 2-15. (Stip. Par. 9.)

11. Each wedding package includes "products of photoprocessing" as defined in § 2-15. *Id.*

12. Taxpayer is considered a "retailer" under the ROT when it sells wedding packages. *Id.*

13. An engaged couple hire taxpayer to take photographs of their wedding day. (Stip. Par 10.)

14. The engaged couple depends on taxpayer to use its expertise and artistic judgment to take professional quality photographs of their wedding. *Id.*

15. Taxpayer's photographer spends approximately 12 hours at the wedding and will take approximately 450 photographs. (Stip. Par. 11.)

16. The photographer takes candid photos during the wedding ceremony and reception, and posed photographs of the bride and groom, their families, the bridal party , and the guests. *Id.*

17. The photographer attempts to "capture the moment" by instantaneously evaluating facial expression, lighting, background and other factors and is responsible for making sure that he has taken pictures of the high points of the ceremony (e.g. cutting the cake) and of all of the participants and guests. *Id.*

18. The photographs are developed by an outside photoprocessing laboratory. (Stip. Par. 12.)

19. Taxpayer assembles the photographs into a book of approximately 435 proofs for the bride and groom to review. *Id.*

20. The bride and groom then meet with a member of taxpayer's staff to select the photographs for their wedding album and to decide on the arrangement of the photographs in the album. *Id.*

21. All of the negatives are owned and retained by the taxpayer. *Id.*

22. The photoprocessing laboratory charges its developing fee to taxpayer. (Stip. Par. 13.)

23. Taxpayer pays the photoprocessing laboratory charges but does not disclose the amount to its own customers. *Id.*

24. Taxpayer's average photoprocessing cost for an album of photographs is 14% of the price of the wedding package. *Id.*

25. Taxpayer purchases the album covers and pages from manufacturers who generally sell them only to professional photographers or to distributors for resale to professional photographers. (Stip. Par. 14.)

26. Taxpayer's average cost for the album cover and pages is 18% of the price of the wedding package. *Id.*

27. Taxpayer transfers ownership and possession of the completed wedding album (i.e., the photographs, album pages, and album cover) along with any picture frame included in the package upon payment in full of the price of the wedding package. (Stip. Par. 15.)

28. All wedding packages include a wedding album but only a few include picture frames. (Stip. Par. 18.)

29. The taxpayer always charges a single price for the entire wedding package, including the album pages, the album cover, or any picture frame. This practice is standard among professional photographers. (Stip. Par. 19.)

30. During calendar year 1989, taxpayer charged ROT on 50% of the price of a wedding package. (Stip. Par. 20.)

31. During 1990 and 1991, taxpayer charged ROT on 10% of the price of a wedding package. *Id.*

32. In December, 1989, the Department published Informational Bulletin FY 90-12, directed to professional photographers. The bulletin advised in part that "If you do not state the charge for photoprocessing separately on the bill, you collect tax on 10% of the total bill. (Taxpayer's Motion For Summary Judgment, Ex. A).

33. On March 15, 1993, the Department issued a private letter ruling to the taxpayer on the issue. The Department stated that if the taxpayer includes albums and frames as part of its wedding packages, it must apportion part of the package price to the albums and frames and charge tax on the full amount so apportioned. (Stip. Par 38, Stip. Ex. No. 23.) This was the first time that any change from previous audit policy on the proper tax to be charged by professional photographers was publicly announced.

34. The Department intends to apply the above interpretation to all wedding photographers as a statement of audit policy. (Stip. Par. 39.)

35. As of the date of this recommendation, the Department has neither promulgated nor published any administrative rule which covers such intended audit policy.

CONCLUSIONS OF LAW:

ISSUE #1

The first issue is whether the Department's interpretation of the so-called "10 percent rule" as it applies to professional photographers under Section 2-15 of the ROTA is proper.

Prior to September 1, 1988, professional photographers were classified for tax purposes as servicemen. As servicemen, if they used outside photoprocessors, the photoprocessors were treated as subcontractors. (See ROT Reg. § 130.2000(a), 8 Illinois Register p. 5326). As a result of Public Act 85-1135, which became effective on September 1, 1988 and amended Section 2-15, professional photographers, in effect, were reclassified as retailers. Because of this change, the Department amended its regulation, effective November 4, 1988, taking the reclassification into account. The regulation (86 Admin Code ch. I, § 120.2000(a)) that was in effect between November 4, 1988 and December 21, 1989 provided as follows:

If a charge for the photoprocessing component is not separately stated, tax is imposed on 50% of the entire selling price. 12 Illinois Register p. 19538.

Section 2-15, was amended a second time by Public Act 86-928, effective September 18, 1989, to read as follows:

For purposes of the tax imposed on photographs, negatives, and positives by this Act, "photoprocessing" includes, but is not limited to, developing films, positives, negatives, and transparencies, and tinting, coloring, making, and enlarging prints. Photoprocessing does not include color separation, typesetting, and platemaking by photographic means in the graphic arts industry and does not include any procedure, process, or activity connected with creation of the images on the film from which the negatives, positives or photographs are derived. The charge for in-house photoprocessing may not be less than the photoprocessor's cost price of materials. In transactions in which products of photoprocessing are sold in conjunction with other services, if a charge for the photoprocessing component is not separately stated, tax is imposed on 50% of the entire selling price unless the sale is made by a professional photographer, in which case tax is imposed on 10% of the entire selling price.³

Following this change in the statute, the Department again amended its regulation to reflect the new language in the statute which provides that if a professional photographer sells products of photoprocessing in conjunction with other services without stating a separate charge for the photoprocessing component, tax is imposed on 10% of the entire selling price. The amendment to the regulation became effective December 21, 1989, and was published in the Illinois Register on January 5, 1990. 14 Illinois Register , p. 261. In relevant part, it reads as follows, precisely tracking the statutory provision:

In transactions in which products of photoprocessing are sold in conjunction with other services, if a charge for the photoprocessing component is not separately stated, tax is imposed on 50% of the entire selling price unless the sale is made by a professional photographer, in which case tax shall

³ The last sentence in Section 2-15, is the "ten percent rule" the construction of which is at issue in this case.

be imposed on 10% of the entire selling price. 86 Admin Code ch. I, § 120.2000(a)

The Department also issued Informational Bulletin FY 90-12 in December 1989, which explained, in question and answer form as follows, how a professional photographer is to charge tax. The language of the bulletin reads:

Question:

I provide service in conjunction with photoprocessing. How do I figure out how much tax to pay?

Answer:

If you are a professional photographer, how you write the bill to your customer will determine how much tax to pay. Here are your choices:

If you state the charge for photoprocessing separately on the bill, you collect tax on that amount.

If you do not state the charge for photoprocessing separately on the bill, you collect tax on 10% of the *total* bill. (If you sell the products of photoprocessing in conjunction with services *other than those of a professional photographer*, you must pay tax on 50% of the *total* bill.) (Emphasis supplied)

If the photoprocessing is done in-house, you must collect tax on no less than the cost price of the materials you used for developing and printing.

The Department essentially repeated this advice in the Spring 1990 issue of Taxation Today. None of these issuances by the Department inform professional photographers that they must allocate a portion of the prices for wedding packages to the album pages, covers and frames that they provide as part of the packages.

The Department argues that the issue in this case is determined by the first sentence of Section 2-15 which reads: "For purposes of the tax imposed on photographs, negatives, and positives by this Act, 'photoprocessing' includes, but is not limited to, developing films, positives, negatives, and transparencies, and tinting, coloring, making, and enlarging prints." The gravamen of the Department's argument is that, beginning with the year the "ten percent rule" went into effect, album pages, covers and frames that taxpayer sells as a

wedding package are no longer part of photoprocessing within the meaning of the statute. The basis for this position is grounded in the fact that these items are not expressly enumerated in the definition of the term. If the Department's theory is correct, the frames and the album pages and covers are being sold by taxpayer at retail so taxpayer should be assessed ROT on an allocated portion of the wedding package prices as retail sales. The allocated portion alone is in excess of 10% of the entire selling price for the wedding packages and is the basis for the Department's assessment in this case.

Taxpayer argues, on the other hand, that the issue in this case is determined by the sentence in Section 2-15 which reads: "In transactions in which products of photoprocessing are sold in conjunction with other services, if a charge for the photoprocessing component is not separately stated, tax is imposed on 50% of the entire selling price unless the sale is made by a professional photographer, in which case tax is imposed on 10% of the *entire selling price*." (emphasis supplied)

The import of taxpayer's theory is that the album covers and pages and frames are all part of the package of photoprocessing services which it is selling for a single price. Since it is a professional photographer, it is therefore required to pay ROT on 10% of the entire selling price of the package.

During the entire audit period, taxpayer charged a single price for the entire wedding package, following standard practice in the industry. For calendar year 1989, taxpayer charged ROT on 50% of the price of a wedding package as specified in the statute. The statute changed, effective September 18, 1989 to require professional photographers selling products of photoprocessing without separately stating a separate charge for the photoprocessing component to pay ROT on 10% of the entire selling price. As a result of that change in the statute, beginning in 1990 taxpayer began paying ROT on 10% of the entire selling price of its wedding packages.

The Department has not assessed a deficiency for 1989 when taxpayer sold the same wedding packages, including album pages, album covers and frames for a single

price and the ROT base provided by Section 2-15 for such sales was 50% of the entire selling price. The Department only changed its interpretation of the statute's coverage when the statute was modified to reduce the rate to 10%. This resulted in the imposition of additional tax for the 1990 tax year and forward.

As set forth above, the Department amended its regulation to reflect the statutory change from 50% to 10%. However, it did not amend the regulation in any way to reflect its new policy or interpretation of the statute as excluding wedding packages, album covers, pages and frames, as it is attempting to do here. Taxpayer's wedding packages were the same product after the statutory change as they were before. The only factor that is different is the percent specified in the statute of the entire selling price upon which the taxpayer must calculate ROT. The Department is now interpreting both the statute and the regulation differently for the years after the percent change than it did for the years before the change, for the assessment at issue. For years prior to the change the Department accepted the taxpayer's interpretation of the statute and regulation that it was to base ROT on 50% of the entire price for its wedding packages without making a separate calculation of ROT for the frames and the album covers and pages. For years after the change, the Department assessed, and now argues, that the album covers and pages must be broken out of the price of the wedding package and taxed separately.

Although I agree that the Department's position in this matter would seem logically correct,⁴ the language of the statute is not as clear as the Department would like one to believe. This is evident from the obvious confusion that has been generated among and between the players in this scenario. (See affidavits and exhibits attached to taxpayer's Motion For Summary Judgment). What mitigates most against the imposition of this particular liability however, is the fact that Department is attempting to apply inconsistent positions *within the same audit*. The fact the Department has changed its interpretation of

⁴ Since professional photographers are considered retailers and not servicemen by the import of the 1998 change in the law, it makes sense that tangible personal property (i.e. album covers and frames) transferred to customers as part of the package be taxed at their full value.

the statute and regulation within the same assessment period creates doubt as to the proper interpretation of the statute and that doubt must necessarily be resolved in favor of the taxpayer.

Taxing statutes are to be strictly construed. Their language is not to be extended or enlarged by implication, beyond its clear import. In cases of doubt, they are construed most strongly against the government and in favor of the taxpayer. Van's Material Co. v. Dept. of Revenue, 131 Ill. 2d 196 (1989). Because the Department does not interpret the statute at issue as requiring any breakout of album covers and frames for that period between September, 1988 and September, 1989, we are left with an impermissible dichotomy in the application of the law. If the Department's position and interpretation of Section 2-15 is correct, then the same requisites would necessarily apply for that early period as the rest of the audit. But such is not the case here. Breaking out album covers and frames and charging tax on 100% of their value for that period prior to September, 1989 was not demanded even though it should have been. (Assuming the Department's position). Since the Department fails to administer its own statute and regulation uniformly when the only difference was the rate to be applied, then a reasonable question arises as to which interpretation of the statute is the right one. Because no rule or regulation has as yet been promulgated which codifies that interpretation, the appropriate meaning of the law remains unclear. As such, I am constrained to hold in favor of the taxpayer.

ISSUES # 2, 3 4

Since the first issue is decided in favor of the taxpayer, it is not necessary to consider these issues as they are moot.

ISSUE # 5

The fifth issue is whether the taxpayer is entitled to fees and other litigation expenses pursuant to Section 10-55(c) of the Illinois Administrative Procedure Act because

the recommendation is to cancel the assessment. Taxpayer's reliance on this section is misplaced.

Section 10-55(c) of the Administrative Procedures Act, 5 ILCS 100/10-55(c), states as follows:

- (c) In any case in which a party has any administrative rule invalidated by a court for any reason, including but not limited to the agency's exceeding its statutory authority or the agency's failure to follow statutory procedures in the adoption of the rule, the court shall award the party bringing the action the reasonable expenses of the litigation, including reasonable attorney's fees.

By its very language, this section provides no basis for the award of fees. The matter herein is a proceeding before an administrative agency. An administrative agency is not a court. Ergo, it does not have any jurisdiction or inherent power to award litigation expenses. Furthermore, the recommendation in this case does not attempt to invalidate an administrative rule. The decision in this cause simply cancels the assessment due to doubts surrounding the applicable interpretation of the statute being examined. Therefore, the taxpayer is not entitled to expenses of litigation and attorney's fees and its request for same must be denied.

WHEREFORE, for the reasons stated above, the Motion For Summary Judgment filed by the taxpayer in this cause is granted and on concurrence of the Director of Revenue, the Department's Notice of Liability should be cancelled in its entirety.

Date

Charles McClellan
Administrative Law Judge